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VOLUNTARY REORGANIZATION OF CORPORATIONS

PAUL R. NEWCOMB

THE prevalence of corporate reorganizations since 1929 might cause us to assume that such reorganizations are of relatively recent origin. One text writer has gone so far as to state, "The problem of reorganizing corporations is of comparatively recent origin, but the problem has rapidly increased in importance as corporations have grown in size." (Gerdes on Corporate Reorganizations, Vol. I, p. 2).

A more correct statement is that because of continued financial distress in business there has been, during the last ten years, more necessity for reorganizing corporations than existed prior thereto. A study of the financial history of business in this country will disclose that every time there has been financial disturbance necessity required the reorganization of some corporations. Section 181.05, Wisconsin Statutes, providing for reorganization after mortgage or judicial sale, has been on the statute books since 1872, so that clearly corporate reorganization has been practiced for a long time.

Tax or security laws which have a bearing on reorganizations will not be discussed, as these require special consideration.

CLASSES OF VOLUNTARY REORGANIZATIONS

Reorganizations of corporations fall into two general classes: First, reorganization where there is no financial difficulty. Such reorganization is accomplished to change the capital structure of an existing corporation, or to provide for the consolidation or merger of two or more corporations. Second, reorganization where the corporation is in financial difficulty because of its inability to pay its secured or unsecured creditors, or both.

REORGANIZATION TO ALTER CAPITAL STRUCTURE

Reorganization, to change the capital structure of a corporation, usually takes place entirely within the corporation. The procedure followed is quite similar to the procedure in the organization of a corporation. The procedure for the reorganization of a corporation, either for the purpose of altering its capital structure, or for the purpose of consolidation or merger with another corporation, may be outlined very generally as follows:

(1) The formation of a new corporation—the capital structure of the new corporation to have such common and preferred stock as is deemed necessary.

(2) If preferred stock is to be issued, the preference to be given to the preferred stock.

(3) The voting rights of both preferred and common stock.

(4) The transfer of all of the assets of the old corporation to a new corporation. The new corporation must assume all the liabilities of the old corporation.

(5) The redemption by call of all outstanding bonds, and provision for a new bond issue by the new corporation.

(6) The liquidation of the claims of unsecured creditors, or provision made for the payment of such creditors by the new corporation.

The foregoing general outline, when considered in connection with *Gudahy v. Tax Commission*, 226 Wis. 317, 328, and *Johnson v. Bradley Knitting Co.* (Wis.) 280 N.W. 688, will furnish a very helpful guide in the reorganization of a corporation not financially embarrassed.

REORGANIZATION OF CORPORATION IN FINANCIAL DIFFICULTY

The voluntary reorganization of a corporation, because it finds itself in financial straits, will be particularly considered. The reorganization of any corporation involves the rights of stockholders, bondholders, unsecured creditors, employees and, in many instances, the public. This is particularly true where a corporation is in financial difficulties. If each of the classes named above fully appreciates the rights of each other class, then reorganization may be accomplished without litigation. Reorganizations, like other matters in which individuals may be interested, can be successfully achieved without litigation where there is fair dealing between the persons interested in the corporation.

The paramount problem in every voluntary reorganization is to discover a plan of reorganization which will protect the rights of every person interested in the corporation, giving due consideration to the priority of his rights without causing any unnecessary injury to others. Unless this principle is fully appreciated by a large majority of those interested in the corporation, and the lawyers representing them, there is no hope of accomplishing a voluntary reorganization.

The procedure followed in voluntary reorganization of a corporation is substantially the same as the procedure followed in the reorganization of a corporation in equity or under the Bankruptcy Act, except that in voluntary reorganization litigation is absent.

THREE PRINCIPAL PARTS OF VOLUNTARY REORGANIZATION

The three principal parts of a voluntary reorganization are: First, the drafting and execution of an agreement appointing a creditors' committee. This committee performs the same functions as a trustee appointed under the Bankruptcy Act, or in an equity receivership where a reorganization is contemplated. Second, the preparation and execution of an agreement providing for the reorganization of the corporation. This agreement is analogous to the plan for reorganization under the Bankruptcy Act. Third, the performance of the agreement of reorganization, which is quite similar to the work necessary in consummating the plan for reorganization under the Bankruptcy Act. Long prior to the enactment of 77B, corporations were voluntarily reorganized where their financial circumstances required reorganization to preserve the interests of creditors and stockholders.

Reorganization under the Bankruptcy Act follows to a large extent the practice prevailing in voluntary reorganization. In voluntary reorganization, the power of a court to compel reorganization is absent and persuasion to this end must be supplied through the efforts of the parties interested in the reorganization and their attorneys, and often by display of power to accomplish reorganization through court procedure. This requires patience, ability, and appreciation of fair dealing on the part of the lawyers representing the various interests.

PRESSURE WHICH MAY BE USED TO EFFECT REORGANIZATION

At times it will be found necessary to display to the recalcitrant parties interested in the corporation powers given to certain majorities of others interested in the corporation. This may be accomplished in various ways. Thus, secured creditors can often convince the stockholders of the feasibility of reorganization by demonstrating that if reorganization is not accomplished to protect the rights of all interested in the corporation, they can and will foreclose on their security, and thus effect a reorganization under Section 181.05, Wisconsin Statutes, in which case the rights of the stockholders will be entirely eliminated. The unsecured creditors as against both the recalcitrant secured creditors and stockholders may threaten to have a receiver appointed, (*Thomsen v. Cullen*, 196 Wis. 581; *Cullen v. Landwehr*, 201 Wis. 247) and after a receiver's sale effect a reorganization in which those not participating in the purchase of the assets at such sale will be barred from the reorganized corporation. Two-thirds of the stockholders on their part may bring pressure by offering to dissolve and liquidate the corporation. Threat of petitioning for reorganization under the Bankruptcy Act may also be used to force a voluntary reorganization. Thus,

while in voluntary reorganization there is absent the power of the court to compel reorganization, nevertheless, the powers given to each class to enforce its rights through litigation are always present, and are often very persuasive in inducing the various interests to agree to a reorganization.

The three principal steps in the voluntary reorganization of a corporation in financial difficulty will now be considered in detail.

SELECTION OF CREDITORS' COMMITTEE

The first and most important step is the appointment of a creditors' committee. The creditors' committee should represent all interests in the corporation, including secured and unsecured creditors, bondholders, common stockholders and preferred stockholders. Where there are many common stockholders, bondholders and unsecured creditors the obtaining of the signatures of all the different interests might appear difficult. However, the difficulty is not insurmountable, and will be overcome when three or four of the principal interests in each class are convinced of the advisability of the appointment of a creditors' committee, because when this is accomplished a majority in each class will fall in line quite readily.

The success of the reorganization will depend to a very large extent upon the personnel of the creditors' committee. Therefore, men should be selected for the creditors' committee who have ability, foresight, integrity and energy. They should also fully appreciate the rights of the various interests in the corporation, and be capable of judging those rights.

RESTORING CREDIT

When it is necessary to reorganize a corporation because of financial difficulty, the corporation is usually unable to obtain credit and has virtually reached a point where it cannot further continue to carry on its business without financial assistance. At this crisis the creditors' agreement becomes operative, and by freezing the claims of those presently interested in the corporation, it is placed in a position where it can obtain credit by reason of the fact that obligations incurred by the creditors' committee are to be paid out of the free assets of the corporation before any other claims against the corporation are paid. A provision in the creditors' agreement to accomplish this is essential. The creditors' committee is usually able to reduce the operating expenses of the corporation by eliminating extravagant practices, excessive overhead and officers' salaries, and by other economies.

An attempt should not be made to reorganize a corporation where the prospects for future success of the corporation are not reasonably

certain. In other words, if the business in which the corporation is engaged is such that it is hopeless to endeavor to carry on the business, then the best for all concerned is to liquidate the business just as orderly and rapidly as possible.

In a large majority of cases, the duty will fall upon the creditors' committee to determine whether or not the corporation should be liquidated or reorganized. In order to make this determination it is advisable for the creditors' committee to operate the corporation for such time as will permit it to reach a conclusion as to whether the corporation should be liquidated, or continued. The creditors' agreement should give the creditors' committee power to make this determination.

AIM OF CREDITORS' AGREEMENT

The dominant aim of a creditors' agreement must be to place the affairs of the corporation in the hands of a creditors' committee, with absolute power on the part of the committee to carry on the business of the corporation and make a final determination as to whether the corporation should be reorganized or liquidated. This may seem like conferring broad powers upon a creditors' committee, but it must be fully realized that the creditors' committee is the doctor which is to endeavor to cure the sick corporation, and unless absolute confidence is placed in the committee, there is very little purpose in attempting to voluntarily reorganize the corporation. Therefore, the agreement appointing the creditors' committee should first provide that the stockholders transfer and assign their stock to the committee. The directors of the corporation must resign, and the creditors' committee elect such directors as it may see fit. Thus, the stockholders, by executing the creditors' agreement, turn over to the creditors' committee absolute control of all of the affairs of the corporation. The secured and unsecured creditors, on their part, must agree to allow their claims to remain in status quo during the period of operation of the corporation by the creditors' committee, including the period of liquidation or reorganization of the corporation. The creditors must agree not to prosecute actions of any kind against the corporation, nor attempt to enforce any of the claims of the creditors, either by action at law or by foreclosure of any mortgage or trust deed during the time the creditors' agreement is effective.

NUMBER TO AGREE TO CREDITORS' COMMITTEE

It is at once apparent that unless a very substantial number of those interested in the corporation agree to become parties to the creditors' agreement, that a creditors' committee cannot operate effectively, be-

cause of the adverse claims which might be made against the corporation. Therefore, it is essential that stockholders holding at least three-fourth of the outstanding shares of both common and preferred stock join in the agreement, and that at least three-fourths in amount of the secured and unsecured creditors join in such agreement. If this number can be obtained, it will rarely be found that the minority will place impediments in the operations of the creditors' committee, and usually this minority will be eliminated either by consenting to the agreement or by settlement of their claims. The creditors' committee should be given power to compromise and pay the claims of those who do not become parties to the agreement. Where the required number of stockholders cannot be obtained, it may be necessary to resort to reorganization through the action of the stockholders at a stockholders' meeting, following to a large extent a procedure somewhat similar to that followed in *Johnson v. Bradley Knitting Co.* (Wis.) 280 N.W. 688.

In order to insure the obtaining of funds and raw material for the continued operation of the business of the corporation, the agreement should provide that all indebtedness of the corporation incurred after the effective date of the creditors' agreement will be paid in full before the claims of unsecured creditors or bondholders are paid, except that such new indebtedness shall not have preference over the lien which secured creditors had at the time the creditors' agreement became effective.

DUTIES OF CREDITORS' COMMITTEE

The appointment of a creditors' committee places new management in charge of the corporation. What this management may do has all the uncertainties attendant upon human endeavor, and therefore, the creditors' committee should be given power and authority to cope with any exigency which might arise. It may happen that the creditors' committee is so successful in the operation of the business that more funds are accumulated than are necessary to reorganize the corporation. Therefore, the creditors' agreement should provide for the payment of dividends on the various classes of claims, and especially for interest on secured indebtedness if funds are available therefor. Where a creditors' committee is so successful in the operation of a corporation that it can continue without reorganization, the committee should turn the management of the corporation back to the stockholders.

TERM OF AGREEMENT

It is advisable not to make any definite term for the creditors' agreement. It is best to leave the duration of the agreement entirely to the determination of the creditors' committee. The creditors' agree-

ment should provide that it will remain in full force and effect until the liquidation or reorganization of the corporation, or until the creditors' committee determines that some other action be taken in reference to the affairs of the corporation.

The creditors' agreement should provide for the appointment by the creditors' committee of agents and employees to represent and act for it, for meetings of the creditors' committee, and for the filling of vacancies in the creditors' committee.

It is essential that the various classes interested in the corporation should be represented on the creditors' committee, and these interests should be represented in proportion to their respective rights in the corporation. In the case of the ordinary corporation, where the mortgage indebtedness covers practically the entire plant, and unsecured indebtedness is large, a fair representation on the creditors' committee of the various classes interested in the corporation will be found to be approximately as follows: Three for bondholders, two for unsecured creditors, one for preferred stockholders, and one for common stockholders. These proportions will, however, vary according to the circumstances of each case, and the variations in the size of the interests of the several classes having an interest in the corporation. The entire creditors' committee, however, must be impressed with the duty to work for the interests of all parties interested in the corporation, and not for the interest of any particular class, with the dominant aim of preserving the corporation if possible, and if liquidation is required, of securing the largest amount for each of the various classes in proportion to their rights in the assets of the corporation. The creditors' agreement should relieve the committee from any personal liability, except for fraud or bad faith.

Provision should be made for the payment of the actual expenses incurred by the creditors' committee, and reasonable compensation to each member of the committee for the time actually spent in connection with the affairs of the corporation. This is advisable because, if the members of the committee receive some compensation for their services, there will be an incentive to perform the services diligently and for the best interests of all concerned. The compensation should not be large, especially where the members of the committee are interested in preserving the corporation because of their own personal interests or the interests of those whom they represent. When the creditors' committee begins functioning, the work of reorganization where possible is usually half accomplished, principally because all interested in the corporation are convinced it must be reorganized, and will cooperate to that end.

AGREEMENT OF REORGANIZATION

After the creditors' committee has taken over the affairs of the corporation, it operates the corporation with the aim of determining what can be done with the corporation which will be best for all having an interest in the corporation. If the creditors' committee determines it is advisable to reorganize the corporation, then an agreement is prepared providing for the reorganization. The creditors' committee should, therefore, be given the right to execute, on behalf of the secured and unsecured creditors, a reorganization agreement, without the necessity of submitting to the various creditors the plan of reorganization as embodied in the agreement.

In actual practice, however, the creditors' committee usually submits to the various creditors and stockholders the plan of reorganization for their consideration. It is very seldom that there is any criticism of the plan. This is because each class is represented on the committee, and the ideas of each class, so far as practical, have been incorporated into the agreement. There may be suggested changes to which the creditors' committee should give due consideration.

The other parties to the reorganization agreement must be the debtor corporation or stockholders of the debtor corporation, and the new corporation which is to take over the business as the result of the reorganization.

The agreement should provide that all of the rights, franchises, property, both real and personal, and all of the other assets of the debtor corporation be transferred to the new corporation.

BONDS OF NEW CORPORATION

The outstanding mortgage or trust deed of the debtor corporation should be liquidated by giving each bondholder the right, at his option, to take capital stock of the new corporation, par for par, for part or all of his bonds, or to exchange part or all of his bonds of the old corporation, par for par, for bonds of the new corporation to be secured by a mortgage or trust deed covering at least as much of the property of the new corporation as was covered by the old mortgage. When the old bonds have been thus exchanged, they are delivered to the trustee under the mortgage or trust deed of the debtor corporation for cancellation, and the mortgage or trust deed satisfied. The agreement should provide for the maturities of the new bonds, rate of interest to be paid, the principal terms of the trust deed, the person or party to be trustee under the trust deed, and that both the bonds and trust deed shall, in addition, contain such terms as are generally found in bonds and mortgages similar to the bonds to be issued and the mortgage to be given.

CAPITAL STRUCTURE OF NEW CORPORATION

While it is impossible to announce a definite rule as to the capital structure of the new corporation which will meet every situation, the following may be used as a guide which, with modifications to meet each particular situation, will be found workable.

(a) Each unsecured creditor should be issued one share of preferred stock of the par value of \$100 per share for each \$100 of the claim of such creditor, and any part of the claim remaining after such allocation which shall not equal \$100 shall be paid in cash out of the funds in the hands of the creditors' committee.

(b) Each preferred stockholder should be issued second preferred stock, to be exchanged share for share for the old preferred stock. The certificates of both classes of preferred stock should contain such terms and conditions as will effectively preserve to each class their rights in proportion to the rights which they had in the old corporation.

(c) Common stock should be issued to the common stockholders so as to preserve the rights they had in the old corporation, which are subordinate to each of the other classes heretofore mentioned.

(d) It is often advisable to give the secured or unsecured creditors, or both, and the preferred stockholders, the option to participate in the issuance of common stock, or to issue to them a percentage of the common stock in addition to the bonds or preferred stock hereinbefore mentioned. This is especially feasible where the claims of the secured and unsecured creditors and the preferred stockholders have been reduced in principal amount through the new issue, or where the yield on the bonds or the preferred stock, or both, is at a low rate. If these interests are thus given an option to take common stock, or are issued common stock in addition to the securities to be issued to them, as hereinbefore mentioned, they may recoup the loss which they sustained by reason of the reorganization, if the operation of the corporation is successful and the common stock becomes of substantial value, or pays dividends.

(e) Provision must be made for paying the expenses in connection with the reorganization, including the organization of the new corporation, the placing of the mortgage or trust deed upon the properties of the new corporation, the issuance of the bonds, and all other expenses incident to the carrying out of the agreement of reorganization.

CONSUMMATION OF AGREEMENT OF REORGANIZATION

When the agreement for reorganization is drafted and executed, the work of reorganization is practically completed.

The performance of the agreement of reorganization is usually accomplished with little difficulty as compared with the two earlier steps, because the principal requirement is the drafting and execution of the various documents provided for in the agreement of reorganization.

It has been attempted to outline in general the procedure followed in a voluntary reorganization of a corporation in financial difficulty. The consummation of a voluntary reorganization where the corporation is financially embarrassed requires patience, ability, industry and perseverance on the part of the attorneys representing the various interests involved. Because of this, the attorneys who guide the destiny of a voluntary reorganization will get much satisfaction upon completion of the job—much more than where the reorganization is accomplished through court procedure.



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UNITED STATES SUPREME COURT, 1939

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